

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Rev and Tax Committee Analyst: Gloria McConnell Bill Number: AB 2896
Related Bills: See Legislative History Telephone: 845-4336 Introduced Date: 03/09/00
Attorney: Patrick Kusiak Sponsor: FTB

SUBJECT: Deficiency Assessments

SUMMARY

This bill, which is sponsored by the Franchise Tax Board (FTB), would allow the FTB to continue its current practice of using tax returns (either paper or electronic) or information electronically captured from tax returns to make deficiency determinations. If a tax return or electronically captured return information is not available, the taxpayer would be notified and have 30 days to provide a paper or electronic copy of the tax return to FTB. Additionally, FTB would be required to provide a statement in tax booklets informing taxpayers that they may be requested to furnish FTB with a copy of the California or federal tax returns that are the subject of or related to a federal audit.

EFFECTIVE DATE

This bill would be effective on January 1, 2001, and expressly would apply to notices of proposed deficiencies issued on or after January 1, 2001.

LEGISLATIVE HISTORY

This provision is initiated in response to a California Court of Appeal decision filed December 21, 1998: Wertin v. Franchise Tax Board (1999) 68 Cal. App. 4th 961. The taxpayer argued the Franchise Tax Board (FTB) failed to issue a valid notice of proposed assessment (NPA) because FTB had not reviewed the taxpayers' tax return prior to issuing the proposed assessment and thus had not validly determined the amount of tax due as required by statute. The FTB argued the trial court erred in applying federal case law and standards to a question of California tax law and FTB was not required to review the taxpayers' actual returns before issuing the notice of proposed assessment. The Court of Appeal held in favor of the taxpayer that a deficiency issued by the FTB was invalid because FTB issued its NPA without reviewing the taxpayer's tax return.

In the Wertin case, the basis for FTB's NPA was a federal audit determination for tax year 1983. The federal determination was final many years after the expiration of California's general four-year statute of limitation (SOL) for issuing NPAs. However, an IRS audit determination reopens the California SOL for issuing NPAs for that audit year. For federal audit determinations that were final prior to January 1, 1993, FTB had six months after receiving adequate notification from the taxpayer of the final Internal Revenue Service (IRS) determination to issue its NPA.

Board Position:

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Department Director

Date

Alan Hunter for GHG

4/4/00

In the Wertin case, FTB did not have the original tax return filed by the taxpayer because the return had been destroyed during the department's routine annual purging of paper files. Returns are retained beyond the general SOL for issuing NPAs if flagged for special treatment, which is generally because an FTB audit is in process or it is known that a federal audit is pending. For Wertin and many other taxpayers, FTB is not aware of a pending federal audit until after California's general SOL has expired, so at the time the federal audit is final, the taxpayer's actual California paper tax return has been destroyed. Also for Wertin, FTB failed to obtain a copy of the return that the taxpayer stated he had in storage.

Although FTB did not review the Wertins' tax returns, it did review information on its records regarding their 1983 tax liability in order to arrive at its deficiency calculation. When a tax return is processed by the FTB, key data are captured and retained on an electronic data base. In the situation where an NPA is issued after a return is destroyed, staff reviews its electronic record that contains a summary of the taxpayer's return information and makes a determination as to the deficiency based on that information and federal information furnished by the taxpayer and/or the IRS.

The Wertin court said that its finding that the assessment issued to Wertin was invalid is consistent with Scar v. C. I. R. (814 F.2d at p. 1369) and federal standards. However, FTB staff disagrees. In Scar, the IRS had made an arbitrary deficiency assessment stating on the notice that since the original income return was unavailable at the time, the income tax was being assessed at the maximum tax rate of 70%. In contrast, in the Wertin case, FTB used information from the taxpayer's originally-filed California return that was electronically captured during return processing as the basis for the assessment.

FTB petitioned the California Supreme Court to review the Wertin decision, but that petition was denied. The case is now final and is a published opinion.

As a result of the Wertin case, any deficiency determination that FTB makes without reviewing the actual paper tax return may be held to be invalid. For the most part, the Wertin decision primarily affects FTB's assessments that are based on IRS audit reports, where the paper return that was filed is no longer available within the department. However, depending upon how the Wertin decision is interpreted, there could be an impact to FTB's current business practice of using electronically captured information whenever possible without pulling the tax return from storage.

SPECIFIC FINDINGS

Under federal statutory law, if there is a deficiency in any tax reported to the IRS, the IRS may issue a notice of deficiency (Internal Revenue Code (IRC) section 6212). Deficiency generally is defined as that amount that exceeds the tax shown by the taxpayer upon his or her return plus amounts previously assessed as a deficiency (IRC section 6211).

Under California income tax law, if FTB determines that the tax disclosed on an original or amended return is less than the tax disclosed by an audit, FTB shall mail a notice of proposed deficiency (Revenue and Taxation Code (RTC) section 19033) to the taxpayer. California generally conforms to the federal definition of deficiency (RTC section 19043).

Under FTB's current practice, all paper returns received by FTB are electronically processed and critical return information is captured to facilitate examining accounts without retaining or retrieving the actual tax return. FTB has many audit processes to determine whether a tax deficiency (or overpayment) exists, which include those cases where the taxpayer has failed to file a personal income tax return. Determining the amount of the deficiency may require manual intervention or may be strictly an automated process. FTB may conduct an audit in the field using the records of the taxpayer or may conduct an audit using the filed tax return and correspondence, return information electronically captured and correspondence, or a combination of all information available to FTB, including IRS audit information. Because California generally conforms to federal law, reliance on a federal audit determination is a very cost-effective method for determining the California deficiency, if any. For example, for fiscal year 1998/99, using the federal audit determination process FTB assessed \$230 million in personal income tax deficiencies, with a benefit to cost ratio of over \$35 to \$1.

As a result of all audit processes, and the taxpayer filing a personal income tax return, approximately \$300 million in deficiency assessments were issued by FTB for fiscal year 1998/99. Staff estimates that of these assessments, the tax return would not have been available for deficiency assessments totaling \$115 million, primarily because of the FTB practice of purging tax returns. Of the remaining \$185 million in deficiency assessments, returns were not retrieved from storage due to FTB's current business practice of using electronically captured data to process NPAs based on federal audit determinations.

Head of household filing status audits historically have proven very cost-effective. For these audits, FTB staff relies on electronically captured return information and questionnaires completed by the taxpayer. The tax returns are not retrieved from storage. For fiscal year 1997/98, FTB disallowed the head of household filing status for approximately 93,000 taxpayers resulting in deficiency assessments totaling approximately \$50 million. The cost effectiveness of these audits would be negated as a result of the Wertin decision if staff were required to retrieve each tax return from storage to make the assessment.

With respect to FTB's current case inventory, approximately 125 cases are under appeal and one case is in litigation where the underlying assessment is based on a federal audit determination. It is unknown whether these specific cases will be affected by the Wertin decision or would be affected by this proposed legislation. Additionally, the number of audits, assessments or protests in process that may be impacted by the Wertin decision or this proposed legislation is unknown at this time.

As an efficiency measure, many tax returns are sent to the FTB electronically. For electronically-imaged returns, a paper document is retained; however, for electronically-filed returns, which include telephone-filed returns, there is no paper tax return. During 1998, FTB received approximately 1 million electronically-filed personal income tax returns (including telephone-filed returns), which was a 131% increase from 1997. So far this year (2000), the electronic filing of 1999 tax returns has increased by 45% over last year at this time; 37% of the 1999 returns are being electronically filed, compared to 27% last year.

The FTB (and IRS) has used an extensive advertising campaign to encourage electronic filing of tax returns because it is more efficient for processing and storage. Furthermore, new technologies are being used to reduce the storage of paper returns. For 1999/2000, FTB will have spent approximately \$6 million to lease approximately 122,000 square feet to store and maintain the personal and corporate paper tax returns under its current business practice of purging files in conjunction with the expiration of the general SOL for issuing a deficiency assessment. The FTB (and IRS) is moving toward eliminating paper tax returns.

Policy Considerations

- ⌚ If the decision made by the Appellate Court in Wertin requires the department to review the actual tax return in lieu of electronically captured information, deficiency assessments totaling approximately \$300 million per year could be at risk of invalidation.
- ⌚ Staff believes the court's finding that the actual tax return must be reviewed before issuing any assessment of a deficiency is without merit since the Wertin's NPA was based on return information that was captured electronically from the actual paper return. This bill would clarify that it is appropriate for FTB to continue its practice of using electronically captured tax return information to determine tax deficiencies.
- ⌚ The Legislature recognized the need for electronic communication and filings by enacting RTC 18621.5, which addresses filings with FTB by "electronic imaging technology" and defining "electronic technology" and "traditional medium." The court's conclusion during a time of major advances in electronic technology is detrimental to the operation of the department and reduces filing options for taxpayers.
- ⌚ To reduce storage costs, add efficiencies, and help simplify the filing process, both the FTB and the IRS are using electronic technology to move toward a paperless filing environment. The Wertin decision could be a major obstacle in achieving this goal.

Implementation Considerations

This bill generally reflects current practice; therefore, implementing this bill would not significantly impact the department's programs or operations.

FISCAL IMPACT

This bill generally reflects current practice; therefore, it would not affect departmental costs or tax revenue.

BOARD POSITION

Support. The FTB voted at its meeting on December 16, 1999, to sponsor the provision contained in this bill.